TESTIMONY OF ROBERT D. HORMATS
VICE CHAIRMAN, GOLDMAN SACHS (INTERNATIONAL)

HOUSE BUDGET COMMITTEE
JUNE 26, 2007

FOREIGN HOLDINGS OF U.S. DEBT: IS OUR ECONOMY VULNERABLE

Mr. Chairman and Members of the House Budget Committee,

It is a great pleasure for me to appear before this committee to discuss an issue of great economic, financial and national security importance to our country — the growing dependence of the United States on foreign capital.

I have been asked to discuss several aspects of this issue, with a focus on the types of events that could lead to a sharp decline or reversal of the large amounts of funds that have been flowing into this country in recent years.

A few words of background might help to put this in context. First, it is worth noting that the U.S. is, and will remain, heavily dependent on foreign capital as long as out country's level of savings remains substantially below its level of investment — as it has been for many years. That imbalance is possible only if foreign investors — individuals, institutions and governments — are willing to finance it through the acquisition of U.S. assets (including stocks, bonds, real estate) or provide direct loans to U.S. entities. The current account balance reflects this savings/investment imbalance and thus tracks the net inflow of investment funds from abroad into the U.S. In 2006 the current account deficit was over $800 billion — roughly 6.5% of the nation's GDP.

The US will continue to be heavily dependent on foreign capital if this large domestic savings/investment imbalance continues. For example, even if the much focused on increase in the U.S. trade and current accounts imbalance with China were to be eliminated tomorrow, the U.S. would still experience the same sized imbalance with the world as a whole if our *internal* savings shortage remained the same — only it would be shifted to different nations. The nation's aggregate current account imbalance, and its dependence on foreign capital, would not be reduced. If we wish to reduce our dependence on foreign capital — and our vulnerability to its sharp interruption — we need to boost savings at home. Without that, the much focused on goal of an adjustment in the dollar/Chinese RMB exchange rate, or any other bilateral measure for that matter, will have negligible effect.

A different set of issues relates to where the capital that fill the U.S. savings shortfall comes from — and the answer is, increasingly, from world's the emerging nations. In recent years there has been a dramatic shift in the current account positions of the emerging economies. This represents their export of surplus savings to the rest of the world — and constitutes a new and unusual feature in the world economy. Their growing current account surpluses collectively are the major counterpart to the growing U.S. current account deficit.

It is *the enormous amount of net savings in these countries — as reflected by their current account surpluses — rather than their reserves or central bank purchases of securities per se* that enable them to be large capital exporters. Although reserves and central bank purchases have receive the lion's share of attention, the underlying factor in their current account surpluses is this *unusually high rate of savings*. And their surplus savings goes to countries that have the largest savings deficits — at the top of the list being the U.S.

Although the world's largest savers have included a shifting cast of nations during the last decade, the vast increase over the last three years comes from two sources: China and the major oil producers. While China gets most of the attention, and has the largest reserves and savings surplus of any nation, collectively the largest increase in savings over the last three years has been by the large oil producers (such as Saudi Arabia, Russia, Iran, Nigeria and Kuwait), who are recycling enormous sums of windfall oil revenues into the world's financial markets.

Recent increases in oil prices caused the value of export revenues of these nations to climb from $743 billion in 2004 to $1.245 billion in 2006 — an increase of $500 billion. About half of that added income was spent on imported goods and services and half was recycled back into global capital markets. Together these countries had a net trade surplus of $533 billion in 2006; but that is expected to fall to below $400 billion in 2007 due to lower oil revenues and increasing level of imports. China's balance of payments surplus continues to rise at a rapid rate and the country recorded a current account surplus of $250 billion in 2006.

It is important to recognize that all of the accumulated savings and surpluses do not necessarily find their way into the foreign exchange reserve holdings of central banks. That occurs when a central bank buys dollars, or other foreign currency, with local currency. For instance, Saudi Arabia might have a large trade surplus, but unless the Saudi central bank buys those foreign currencies up from private holders and corporations with its local currency, the riyal, they will *not* be added to its reserves. If a country does intervene in the currency markets, e.g. China buys up dollars with its currency, the RMB, the dollars *are* added to its reserves. Much of the reserve accumulation of recent years has occurred because foreign central banks buy dollars that they earn on the trade account or that come in as the result of foreign investment or speculation in their local currency to avoid a sharp rise in their currencies vis-à-vis the dollar, and then put dollars they buy into dollar denominated assets which they add to their reserves.

All told, as of May, 2007 China's foreign exchange reserves amounted to over $1.2 trillion; Japan, $887 billion; Russia, over $250 billion; and South Korea, $244 billion. Of China's reserves, over $400 billion is held in the form of U.S. Treasury securities and — based on recent estimates — between $300 and $400 billion in the securities of U.S. agencies, dollar denominated issues of the World Bank and corporate bonds. All told, foreign official holdings of U.S. Treasuries are approaching $1.2 trillion. But, it is again worth emphasizing that America's dependence on foreign capital — and outstanding foreign holdings of American assets — would be just as great if none of the dollars in the hands of foreigners were added to central bank reserves, but instead remained in private hands.

The enormous increase in the global accumulation of net savings and their investment in the U.S. financial market are key factors producing, inter alia, very low real interest rates in this country, which in turn has helped to fuel the U.S. housing boom and other aspects of growth. They also have been instrumental in narrowing credit spreads between the highest rated creditors and lower rated creditors, because lower interest rates encourage investors to push money into higher yielding assets — usually of lower quality — and thus push down interest rates on those securities as well.

THE IMPACT OF A REDUCTION IN CAPITAL FLOWS

The heavy reliance of the U.S. on capital flows from abroad raises the question of the likely impact of a reduction or reversal of those flows on the U.S. economy and financial markets. There are several possible scenarios for this occurring.

Benign Scenarios

A relatively benign scenario is already at play among the oil producers — not as the result of a any conscious effort to cut off funds from the U.S. or any other country but as the result of lower prices for their exports (until recently) and their rapidly growing demand for imports as they use their added wealth to build new public infrastructure and factories and to boost domestic consumption. Their trade surpluses are expected to fall from an annual level of $533 billion in 2006 to under $400 billion this year to under $300 billion in 2008, which means they will have less available savings to invest abroad.

Similar developments are likely to occur in some of the other surplus countries, for instance in the emerging markets of Asia, other than China. China itself is likely to continue to record substantial additional trade surpluses and thus generate substantial amounts of excess and exportable savings for several years at least. But even that could eventually change as domestic demand grows due to a broadening of domestic consumption and purchasing power (as the Chinese government seeks to increase living standards in central and western China and especially in rural areas which feel left behind by the surge in urban prosperity) and improved capital markets that enable the Chinese to use more of their large savings at home rather than exporting such a large portion abroad. These are rather benign and *demand led* scenarios — that could evolve over time and enable adjustment to be quite smooth. But they should also serve as a reminder that the U.S. cannot indefinitely relay on abundant supplies of external capital.

In the case of a gradual decline in net available savings from, say, China the impact on the U.S. rest of the world would be gradual — increasing real interest rates and widening interest rate spreads between the best credits and lower rated credits. However, as noted above, this would be less of an interest rate story than a demand story, as higher domestic demand in China would boost U.S. and other nations' exports to that nation and would channel more goods produced in China away from the world export market into meeting domestic demand.

Disruptive Scenarios

But what if the scenario were less benign? Suppose, for instance, a high savings nation such as China or Saudi Arabia or Russia were to consciously and abruptly shift a large portion of its funds away from the U.S. dollar market and put them into assets denominated in other currencies? That risk is often posed in discussions over U.S. dependence on foreign capital. The likelihood of China, for instance, doing this in current circumstances is very low because such a move would be profoundly disruptive to its trade and therefore, to its domestic economy. One of the reasons authorities in Beijing have adopted a gradual approach to currency revaluation is that too rapid an appreciation of the RMB vis-à-vis the dollar would weaken the competitiveness of PRC exports in the U.S. and other dollar markets and that would slow the growth of jobs in China, risking social unease in a nation that has to find new jobs for some 30 to 40 million people annually.

But were such a scenario to occur, there would be significant implications for U.S. financial markets and the U.S. economy. Let's suppose, hypothetically, there were a major dispute that caused a large creditor nation to deliberately shift a substantial portion of its foreign exchange accumulation to other currencies, such as the Euro. In that circumstance, the dollar would drop sharply and interest rates in the U.S. would spike, as a savings-short American economy would find itself with insufficient funds. As the dollar fell and bonds weakened, other investors, foreign and American alike, could sell off dollar assets and buy those denominated in other currencies.

Such measures would cause a sharp drop in bond prices and thus higher interest rates as the government and corporations scrambled to obtain needed capital. That would produce a market slowdown in U.S. growth — or possibly a recession. Of course, as the dollar dropped and interest rates rose in the U.S. those countries that were the recipients of this new money — the result of investors fleeing dollar assets — might well come to see American assets as a desirable investment and buy them, helping to reverse the deterioration. But this would likely take a lot of time — and considerable damage could be done in the interim.

Highly Disruptive Scenarios

Other scenarios would be even more worrisome. Consider, for example, the implications of a terrorist attack on America's physical infrastructure — such as a dirty bomb that renders a large section of an American city uninhabitable for decades, or incapacitates a large American port such as Long Beach or New York, or an anthrax attack in a major airport, railway stadium or subway system that takes many months to clean up. In such circumstances, foreign investors, particularly foreign private sector investors, would perceive a significant risk to their U.S. investments.

One response would be to sell their stocks, causing a plunge in the U.S. market — already doubtless rocked by the attack. And the budget deficit would widen significantly after such an attack — due to weaker revenues resulting from the decline in and disruption of economic activity after the attack and the need for tens or even hundreds of billions of dollars of added government spending for reconstruction, recovery and retaliation. Foreign central banks then might be reluctant to add to their already large stock of U.S. government assets, pushing up interest rates and thus further harming an already damaged economy.

And even if central banks did not panic into selling dollars, and continued to buy dollar assets at their accustomed pace, private holders of dollars might engage in panic bond selling or simply hedge by selling dollars for foreign securities. As noted above, not all foreign held dollar assets are in the hands of foreign central banks. Enormous amounts are held by large financial institutions such as insurance companies, pension funds, and corporate treasuries as well as by individuals. And many American institutions and individuals might engage in similar behavior as they see the dollar drop and bond and stock prices fall. Whether a massive joint effort by central banks could counter this sharp sell off is highly questionable. And it doesn't need to be a terrorist attack to trigger such a calamity; a devastating earthquake or a catastrophic hurricane could have similar effects.

How much damage would be done, and for how long, would likely depend on the soundness of America's fiscal policy and the nation's overall financial soundness at the time. It is worth recalling that the country had recorded four years of budget surplus before 9/11 and at the time was paying down earlier accumulated debt; also it was far less dependent on foreign savings than it is today (the current account deficit was only 4% of GDP compared to 6.5% today).

By most projections, this imbalance will grow in the future. Sharply rising Social Security, Medicare and Medicaid payments plus climbing interest payments on the federal debt will produce bloated deficits and rapidly rising debt levels. And given the nation's low savings rate, these would entail even greater dependence on foreign capital and still greater amounts of dollar holdings in foreign central banks and institutional accounts if, in fact, foreigners continued to be willing to supply funds abundantly during this period.

In such circumstances, a catastrophic terrorist attack would be far more likely to cause large numbers of foreign investors to curb flows of capital to the U.S. or sell off dollar-denominated assets, and to cause Americans to do likewise, than were the nation in better financial shape — with a budget surplus, a far lower level of domestic debt, and less holdings of dollars abroad. Even if there were significant central bank cooperation to mitigate the financial implications of such an event, the task would be made more difficult if this nation's underlying fiscal position had been eroded by a widening of domestic and international imbalances.

Because we know that one of the stated objectives of terrorists is to cause massive disruption in the U.S. economy, such financial vulnerabilities could lead potential perpetrators to feel that they can do a great deal of damage not simply by their initial act, but also because of the secondary and tertiary economic disruptions that would occur because of the subsequent turmoil in a more vulnerable financial environment. In finances as in military affairs, vulnerability frequently invites aggression.

ALEXANDER HAMILTON AND "THE PRICE OF LIBERTY"

So a key point in determining the implications of such scenarios is the soundness of American finances at the time. In the book that many of you have before you, *The Price of Liberty: Paying for America's Wars,* I trace the history of American wartime financing from the Revolution, through the War of 1812, the Civil War, the two World Wars, and the Cold War to the present.

Alexander Hamilton recognized from the very beginning that America's financial strength was vital to its security. If the country did not manage its finances well, he reasoned, it would not have the resources needed to defend itself in time of war and it would lose credibility in the eyes of creditors, making borrowing in time of war or other national emergency all the more difficult. He was especially zealous about maintaining the confidence of foreigners, whose funds had been critical to the Continental Army's success in the Revolution. Failing to retain their confidence, he surmised, would mean that they would be reluctant to lend the nation money in a crisis, rendering its economy vulnerable to disruption and perhaps depriving it of the resources to defend itself.

Over two centuries have passed since Hamilton held office, but these principles are just as relevant today. And *indeed this nation is more dependent on foreign capital during this war than during any in our history.*

The Iraq War is the first significant conflict during which the U.S. has not raised taxes, cut non-security domestic spending and has relied so heavily on foreign funds to finance its budget deficit. During all other major wars, taxes were increased, non-security programs were cut substantially, and borrowing was financed almost entirely by Americans. While the current war represents only a small portion of GDP — around one percent per annum compared to World War II, over 35%; the Korean War, over 10%; and the Vietnam war, a bit less than that —

it soon will become the second most expensive war in American history, second only to World War II. It represents such a small portion of GDP because the underlying economy has grown so dramatically during the last 60 years.

But that does not mean that future funding for national security will be easy.

- First, as after the Vietnam War, there will be demands for a large "peace dividend" after the U.S. leaves or downsizes in Iraq;

- Second, many national security needs — of the military, the intelligence community and homeland defense — have been postponed as the Iraq War has sucked up roughly $100 billion annually in budget resources. Many of these will need funding in the future;

- Third, the government will have a large bill to meet the medical needs of wounded veterans for decades to come;

- Forth, entitlement payments will grow dramatically in the next decade, possibly squeezing down the discretionary portion of the budget, of which defense constitutes the single largest component. If that is to be avoided, taxes will have to rise and/or borrowing will have to increase; and,

- Finally, if the U.S. remains a savings short economy and borrowing needs rise due to increased entitlement payments and growth in other areas of the budget, dependence on foreign funds will increase, adding to the county's vulnerability in the face of a disruption of such funds.

All of this suggests that reliance on foreign capital will increase and that as this nation attempts to meet its domestic social agenda and its national security agenda we run the risk of greater vulnerability to a disruption in the flow of foreign funds. Stepping up to the hard realities of putting our entitlement programs on a more sustainable footing, developing a multiyear strategy to fight the War on Terror and meet other security needs, while ensuring the fiscal resilience to address unexpected demands on our nation, will be a major challenge for this and future Congresses and for the next president.